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E.O. 12958: N/A
TAGS: EINV PREL ETRD EMIN ENRG PGOV MG
SUBJECT: Mongolian Parliament Passes Long Awaited, Absolutely Essential Mining Deal

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¶1. (SBU) SUMMARY: On August 25, the Mongolian Parliament amended four key laws, which will allow the government to sign and execute the much anticipated agreement for the Oyu Tolgoi (OT) copper and gold project. This immense project promises to generate tens of billions of dollars, and finally overcomes long delays stemming from fears of the loss of sovereignty and resource nationalism. A strong Prime Minister and economic troubles motivated the government of Mongolia (GOM) and Parliament to negotiate and accept a deal that balances company revenue and operational priorities with GOM tax and development needs. While much remains to be done over the next six months to finalize all its terms, the deal represents a success for U.S. commercial diplomacy and has cemented the U.S.'s position among the key players in crafting these sorts of agreements in Mongolia. Other donors are generally positive, but lingering concerns remain that the GOM gave away too much in some aspects of the deal. END SUMMARY.

Background of a World Class Copper Mine

¶2. (SBU) On August 25, the Parliament of Mongolia amended four key laws, which will now allow the government of Mongolia to move forward on signing and executing the long- delayed agreement for the massive Oyu Tolgoi (OT) copper and gold project with Ivanhoe Mines of Canada and Rio Tinto. Situated in the middle of the Gobi desert, the OT deposit is world class in every dimension. With an estimated mine life of over 100 years, the mine itself is titanic. Construction costs alone will top USD seven billion, as the mine will require three complex and expensive shafts and tunnels systems

be hewn out more than one kilometer below the desert surface. Over the next forty years OT will conservatively yield 44 million tons of copper and 1,800 tons of gold. At current market prices that equals USD 264 billion and USD 55 billion respectively. And all this immense activity will occur within a nation with a GDP yet to top USD six billion annually.

World Economy Drives Mongolians to Strike a Deal
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¶3. (SBU) Negotiations have foundered for nearly six years for a variety of reasons. Mongolian concerns about loss of sovereignty over its territory -- specifically that the mining rights holder, Ivanhoe Mines (or any other private firm with similar rights), would sell the mine to China; concerns that Mongolia would not get its fair share of the mine's output; and concerns that the firms would ruin the land without restoration. Even the 2006 entry of Rio Tinto, a world class miner committed to best practices, as a partner in the mine failed to allay Mongolian fears.

¶4. (SBU) Two factors intervened over the last year that fundamentally changed the game for reaching a deal. First, a Mongolian politician with sufficient clout, Prime Minister Bayar, made passage of OT a cornerstone of his government. Second, the economic crisis severely crimped a Mongolian economy and government extremely dependent on mineral revenues. Using concerns over economic collapse, the PM and his team have spent the last year pushing the GOM and Parliament into negotiating and approving the deal before RT and Ivanhoe departed for greener pastures. Significantly, Bayar formed a coalition government even though his party held a strong majority, and backed his commitment to working across party lines by appointing opposition party members as the Ministers of Finance and Environment. Their leadership role throughout the negotiations was essential to achieving yesterday's

result.

¶5. (SBU) Under current law, the GOM has the authority to strike whatever deal it wants within the confines of existing law -- but if the deal goes beyond the current law, then the Parliament has to amend the law to allow the deal to move forward. In the end, it came down to altering four main laws on roads, water, the windfall profits tax, and corporate tax respectively before a formal signing of the agreement. Parliament completed these amendments on the night of August 25, and the GOM plans to sign the agreement next week. It will then receive its first USD 100 million of a USD 250 million advance payment. Within the next six months the GOM must fulfill other conditions precedent to activate the deal fully (septel will describe these other conditions). If the GOM fails to do so, the deal may once again fall into jeopardy.

¶6. (SBU) For reference, para 14 provides a more detailed overview of the basics of the deal.

GOM View of the Deal

¶7. (SBU) GOM and Parliamentary sources expressed general satisfaction with the deal. They are collectively representing it as a win for Mongolia in that they have received a share of the project for the state at no immediate cost or risk to Mongolia; gave no special revenue grants to the companies; obtained clear commitments from the companies to value-added activities in Mongolia; and will receive USD 250 million in up-front monies.

¶8. (SBU) From a purely political perspective, the PM's adherents claim that this success validates the PM's goals and strategies (in particular the coalition), and they claim they will draw on this success in the 2012 Parliamentary and 2013 Presidential elections. It will cement these features into the next election cycle in 2012. Regarding Mongolia's strategic-diplomatic policies, our contacts suggest that passage of the bills should be seen as Mongolia's firm commitment to its third neighbor policy within the realm of commercial activities. (Note: Echoing and supporting this claim is the signing of uranium deals between Russia's President Medvedev and Mongolia officials that occurred at the same time as Parliament Passed the OT bills. End Note.)

Company Perspectives on the Deal

¶9. (SBU) RT and Ivanhoe reps, initially jubilant about the passage, soon lapsed into sober ponderings of the difficulties that will attend implementation. They are satisfied that the current deal will allow them to mine profitably, because it removes a crippling windfall profits tax and allows the company flexibility on labor, technology, taxes, and other issues. In addition, the deal will let the firm recover costs more easily through adjustments to loss-carry-forward rules and an investment tax credit. The companies are already moving to hire more workers and re-start long-delayed equipment purchases and contracting. By summer 2010, company reps estimate the current 400-person workforce will hit 1,000 strong, not to mention the more controversial 2,000-strong Chinese labor force run by U.S. contractor Fluor Corporation that will build the adjacent open-pit mine and associated facilities.

¶10. (SBU) Corporate exuberance over these issues is also tempered by concerns about the GOM's ability to fulfill all conditions precedent within six months of the signing of the agreement. The companies are keen for PM Bayar to designate an OT czar to shepherd the project through the next six months and perhaps beyond. For

example, the companies will have to manage a grueling permit and licensing process that will require over 6,000 licenses for the mine and all its adjuncts.

Donor Perspectives

¶11. (SBU) While most donors support the OT deal, some noted that the deal gives too much to the companies. One, which has been advising the GOM on OT revenue provisions during the negotiations, went so far as to say the management fee the firms will charge is unprecedentedly high, but provided no details to substantiate the claim. However, all agree that the deal is sufficient, workable, and can be improved down the road.

U.S. Views of the Deal

¶12. (SBU) COMMENT: The deal is not perfect, but we share the opinion of most observers that it balances state and private interests in a way that allows all sides to claim victory. One of the key accomplishments is that the deal will set a pattern for all sides to follow in similar projects, the next one being the Tavan Tolgoi coal project, in which we have both commercial and policy interests. Commercially, the OT deal is already proving a boon to U.S. interests, with the Department of Commerce Advocacy Recipient, the Fluor Corporation, set to have its contract re-activated.

¶13. (SBU) Over the last six years, Post has steadily built up relations with industry and the GOM that allowed both sides to avail themselves of a player perceived of as non-partisan, reliable, and fair. These qualities made Post the go-to Mission for verifying respective intentions. The value of this relationship proved itself in the last and most difficult phases of the talks, when the GOM was plumbing the intentions of the companies and Mongolia's actual chances to replace Western participation with Chinese or Russian partners(among others)if the Western firms proved too intransigent. Coordinating with other missions and the donors, we sent a clear and credible, message to the GOM that it was in Mongolia's best interest to work out its disputes with the Western firms, and to the companies that the GOM was committed to reaching a deal. END COMMENT.

Basics of the Deal

¶14. (SBU) The basics of the deal struck are as follows:

GOM Rights and Obligations

-- The GOM will, upon fulfillment of all conditions precedent, receive 34 percent of the mining project, which it will purchase through financing provided by RT and Ivanhoe. After this purchase is complete (perhaps 10-20 years), the GOM may seek to acquire another 16 percent.
-- The GOM guarantees that the current deal will run for 30 years, with right of two 20 year extensions.
-- The GOM undertakes to pay RT and Ivanhoe a management fee to operate the mine.
-- The GOM will assist the project with all permits and licenses and establish a working group of GOM and company representatives to work out regulatory and legal hurdles, including but not limited to customs, labor, health and safety, environment, and inspections.
-- The GOM will allow the project to build and operate roads, power facilities, and water facilities related to the project. In addition

the GOM will allow the project to obtain power from China for up to ten years so long as the project commits to local generation within that period.
-- The GOM will revoke the current 68 percent windfall profits tax (WPT) by 2011 and extend loss-carry-forward provisions from two to eight years. The GOM will must also certify that the project can take a ten percent investment tax credit allowed by law within the next six months.
The GOM undertakes within the next six months to amend seven currently unspecified laws affecting development of the project.

Company Rights and Obligations

-- RT and Ivanhoe will commit to an advance payment (in the form of a loan) of USD 250 million paid in three tranches upon completion of conditions precedent, details of which have not been fully released.
-- RT and Ivanhoe will pay all current royalties, corporate taxes, social insurance taxes, customs duties, and VAT taxes without receiving special treatment.
-- RT and Ivanhoe will follow all environmental rules, labor, and health and safety rules.
-- RT and Ivanhoe commit to adding value in Mongolia by hiring locally wherever possible, training local labor, and to building a smelter (upon proof of commercial viability).

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